

Israel and South Africa: Prospects for their transitions

The current transformations in both Israel and South Africa are driven more by global economics than domestic politics. This implies that the peace process in the case of Israel, and the transition toward a non-racial democracy and open economy in South Africa are much more resilient to political setbacks than is commonly assumed. By the same token, however, both processes are vulnerable to commodity price instability.

Over the next few years, the prospects for both transitions are good. The longer-term outlook, however, will depend on whether standards of living rise in the Middle-East and employment growth accelerates in South Africa.

In our January 1995 issue of the *Emerging Markets Analyst* ("The Political Economy of Peace"), we argued that the Israeli and South African transitions were firmly supported by their business elites and were therefore far less risky than what was apparent at the time.

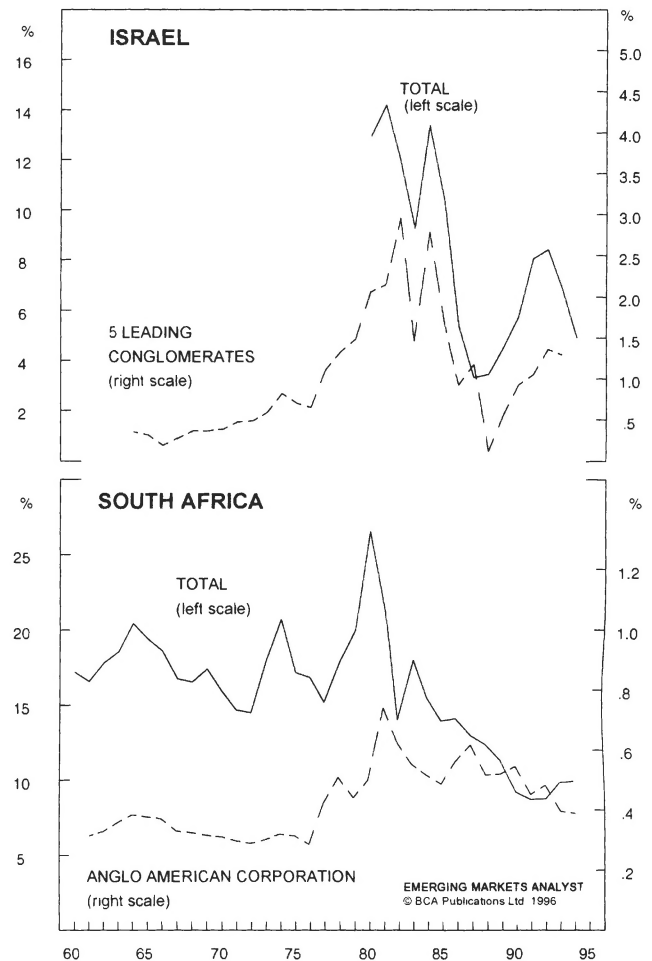
Developments during the past year lend credence to this view. In Israel, numerous terrorist attacks and political killings by Palestinian and Jewish extremists, culminating in the assassination of Prime Minister Rabin, have done little to derail the peace process, although they have intensified political divisions within Israel and among the Palestinians. Similarly, in South Africa, the ANC-led government has stuck to its conservative policy agenda of fiscal and monetary restraint, and continues its course toward liberalization and privatization despite the bleak economic prospects facing the black majority and the consequent surge in crime.

In both Israel and South Africa, the strength of the processes derives from the *need to reverse a protracted profit crisis*. As illustrated in Chart 1, the ratios of net profit to GDP in the two countries have collapsed since the 1980s. For the leading conglomerates in the two countries, the decline constituted a sharp retrenchment from the earlier rapid uptrend. These profit shares are now showing signs of reversal, but a renewed uptrend will likely be sustained only if peace prevails in the Middle East and if democracy consolidates its hold in South Africa.

Growth and profits in Israel

Broadly speaking, profit growth is determined by two basic variables. In the long term, the main factor is

CHART 1: NET PROFIT AS A SHARE OF GDP



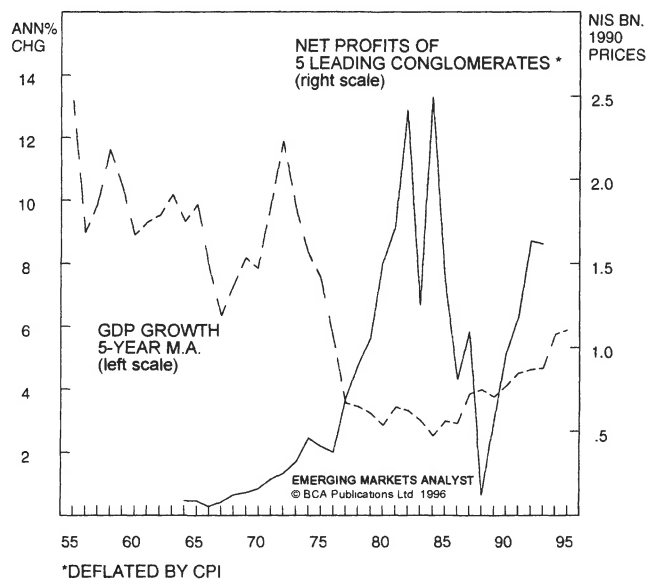
the growth of output. Over the shorter haul, however, fluctuations in the relative share of profit in that output are more important.

In Chart 2, we contrast the net profits of the 5 largest Israeli conglomerates (expressed in real terms) with overall GDP growth.¹ In macro economic terms, Israel entered a protracted recession during the early 1970s. From a micro economic perspective, however, profit growth for the large conglomerates began to soar precisely when the economy nose-dived. Decelerating output for these firms was more than offset by a surge in their profit share, as evident in Chart 1.

The main reason underlying the soaring share of profit was inflation, which started to rise as the

¹ The conglomerates include Bank Leumi, Bank Hapoalim, Israel Discount Bankholding, Koor Industries and Clal.

CHART 2: ISRAELI PROFITS AND GROWTH



economy began to decelerate (Chart 3). Similarly to the experience of many Latin American countries, the Israeli inflationary process proved highly beneficial for the large conglomerates. During the 1970s and early 1980s, their banking arms enjoyed financial spreads in excess of 50% and gained handsomely from systematically rigging the stock market.

However, under conditions of stagnation, there is a natural ceiling on the share of profits in an economy. By the early 1980s, social tensions in Israel began to mount and the difficulty of "regulating" equity prices became apparent. In 1983, the stock market bubble burst, followed by falling inflation and collapsing profits for the large conglomerates.

CHART 3: ISRAELI GROWTH AND INFLATION

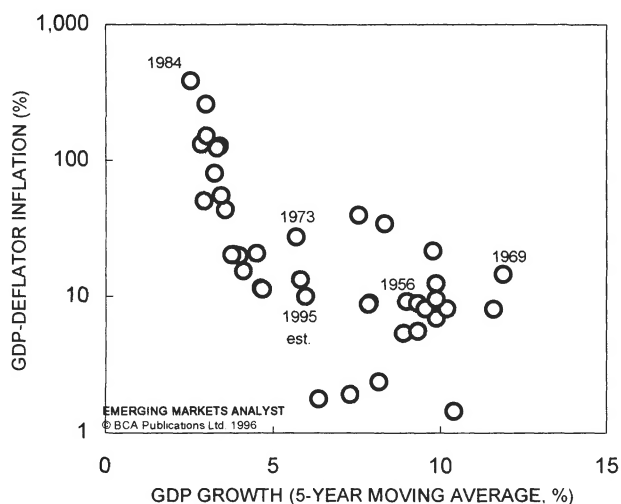
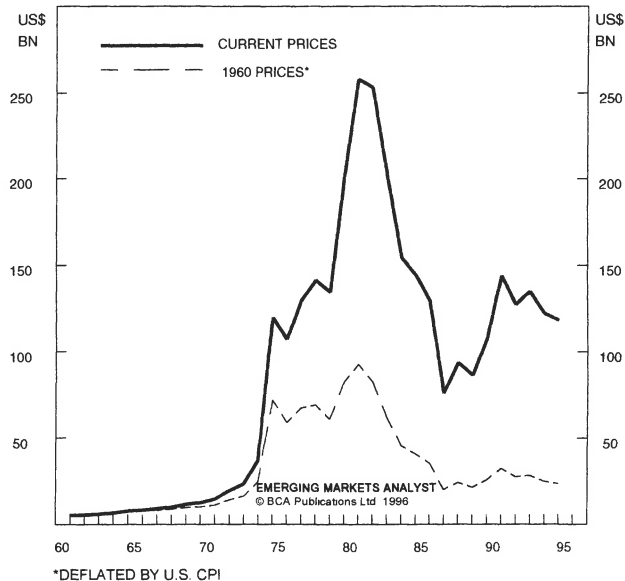


CHART 4: OPEC OIL EXPORTS



The "New Middle-East Order"

The end of the "inflation regime" has been precipitated by changing international circumstances. During the 1970s and early 1980s, Israel received massive financial assistance from Washington, which also consented to Israel's highly protectionist trade policies and concentrated market structure. In return, Israel imported large quantities of US military hardware and helped protect US interests in the region.

During that period, capital grants from the US and trade barriers at home shielded the large Israeli business groups from foreign competition, enabling them to benefit from the inflation spiral despite the protracted recession.

Since the late 1980s, however, the global circumstances underlying US-Israeli relationships have changed markedly. On the one hand, the collapse of the Soviet Union has brought an end to superpower confrontation in the region. On the other hand, the combination of weak oil prices and rising Islamic fundamentalism created a new challenge for US interests in the region.

The source of the problem is illustrated in Chart 4. Petroleum revenues for OPEC have plummeted since 1980, and although there was some improvement as oil prices recovered from their 1986 trough, when measured in real terms these revenues are still 75% below their peak level in 1980.

The collapse of petroleum revenues had devastating consequences for the region's oil exporting economies. As indicated in the table below, overall GDP

growth was more than offset by rapid demographic changes which saw the populations of these countries more than doubled in just 25 years. The result was a toxic brew of internal discontent, whose main reflection has been the rise of Islamic fundamentalism throughout the Middle East.

	% change in GDP per capita since 1970	% change in GDP per capita since peak	% population growth since 1970
Kuwait	-70.7	-70.7 (1970)	+119
Libya	-66.2	-67.2 (1980)	+147
Iraq	-53.8	-82.4 (1980)	+106
Iran	-16.3	-47.6 (1976)	+108
Saudi Arabia	+32.8	-34.5 (1980)	+176

SOURCE: IMF; *World Military Expenditures and Arms Transfers*

The US strategic response to these developments was to create a pro-western "axis", stretching from Turkey, through Syria, to Lebanon, Israel, Jordan and Egypt (with possible satellites such as Morocco and Tunisia). Unlike the oil producing countries, these economies have suffered less (or even gained) from the oil slump, and as Chart 5 shows, their GDP per capita levels have generally been trending upward since 1970. By adopting liberal economic policies, bolstered by western military assistance, this bloc of countries could offer an ideological and military barrier against the rising regional tide of anti-western sentiments. For the

longer term, the hope is that this will be the seed of an "emerging" Middle East.

The creation of this axis is the main force underwriting the current Arab-Israeli peace process.

The "New Middle-East Order" altered the relationships between Israel and the United States, and as consequence forced a fundamental restructuring of the Israeli economy. This restructuring includes a dramatic downsizing of Israel's military industries, the lowering of trade barriers and the dismantling of the old conglomerate structure in order to make room for incoming FDI. So far, the consequence has been a combination of investment-propelled growth and lower inflation.

However, for the Israeli conglomerates, who already dominate their local market, the peace prize comes from *outward* expansion. Most of the leading companies are now forging alliances and ownership ties with leading US and European multinational companies, with the primary aim of expanding into emerging markets.

Given that their presence in emerging countries is still negligible, the large Israeli conglomerates see further export and investment penetration into these markets as a primary source of future earning growth. Chart 6 shows the progressive maturation of Israeli exports, whose growth rates have gradually declined from 20% in the 1950s, to 8% in the 1980s. The geographical distribution between developed and developing countries was fairly stationary until the late 1980s. Since 1990, however, the growth patterns diverged. Export growth to industrial countries

CHART 5: GDP PER CAPITA*

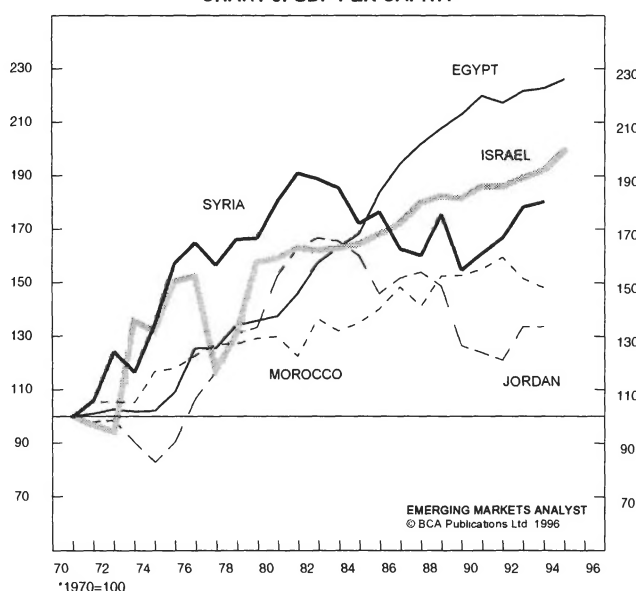
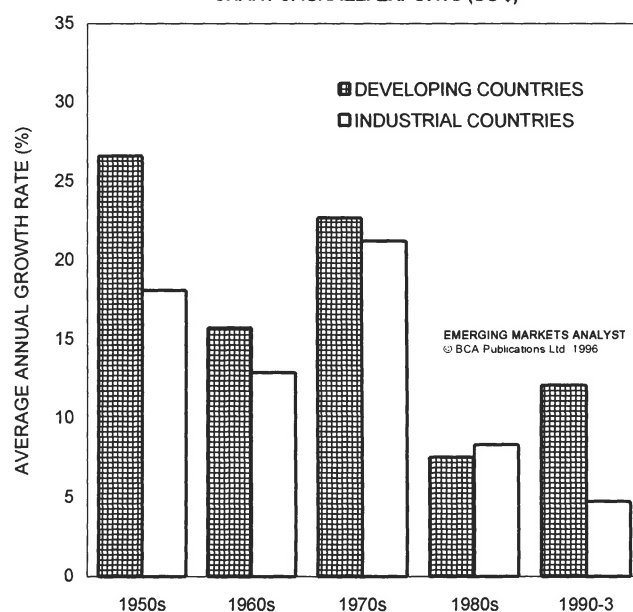


CHART 6: ISRAELI EXPORTS (US \$)



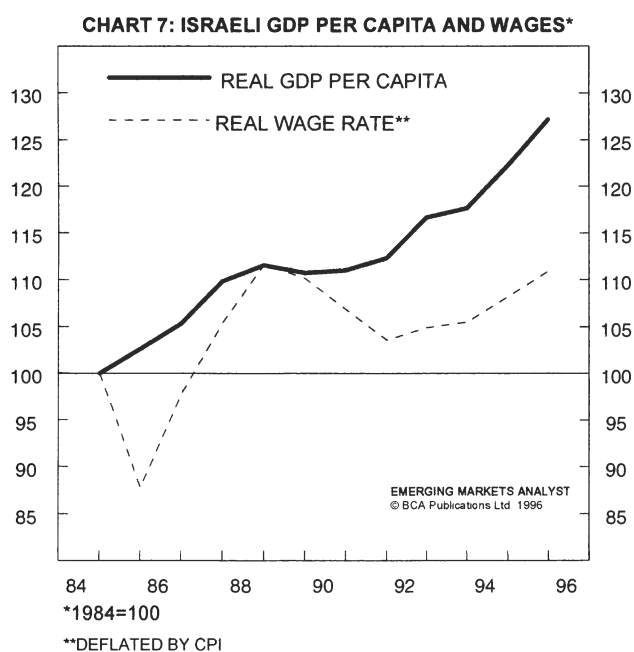
slowed further to 5%, but with the unfolding of the peace process and the weakening of the Arab boycott, export growth to the emerging markets surged to 12%.

For Israel's economic elite, peace is thus both necessary and desirable. On the one hand, US interests in the regions prohibit the continuation of a closed war economy. On the other hand, globalization means that rapid sales growth outside of Israel could eventually substitute for forgone inflationary gains.

The risks

Although much attention is given to developments within Israel, the principal risks to the peace process are international in nature.

Domestically, the territorial compromise with the Palestinians and Arab neighbours has created deep cleavages within Israeli society. Significant segments of the Jewish population, both in Israel and in the occupied territories captured during the 1967 War, have benefited from the previous war economy. Until the late 1980s, this took the form of generous government subsidies and of protectionism which kept wages sheltered from international competition. Over the past five years, however, import penetration and massive immigration from the CIS increased competition in the labor market, causing real wages to lag the surge in GDP per capita (Chart 7). Similarly, for many Israelis residing in the occupied territories, peace spells dislocation and the loss of numerous economic perks.



Thus, despite greater support for the Labor party following the assassination of prime minister Rabin, popular discontent could still oust it from office in the coming elections which are due before November 1996.

However, a victory for the opposition Likud party is not likely to reverse the peace process. Apart from foreign policy, the Likud's platform is practically indistinguishable from Labor's neo-liberal agenda. Given that this agenda is contingent on liberalization and open borders, it is not clear how the Likud could return to regional isolationism. Indeed, with heightened expectations for "peace dividends", any attempt to slow down the peace process will pit Likud against the US administration, against the domestic conglomerates, and against the large multinational corporations which now invest in Israel as a base for regional expansion.

As Israel integrates into the world economy, the main uncertainties regarding the peace process will hinge on developments in the Persian Gulf. Even if the Arab-Israeli peace does bring economic development and faster growth, that in itself may prove insufficient to compensate for forgone oil revenues. In order to contain internal social tensions, the oil producing countries still need to boost these revenues, and in the context of a global deceleration that could be done only by raising the price of oil.

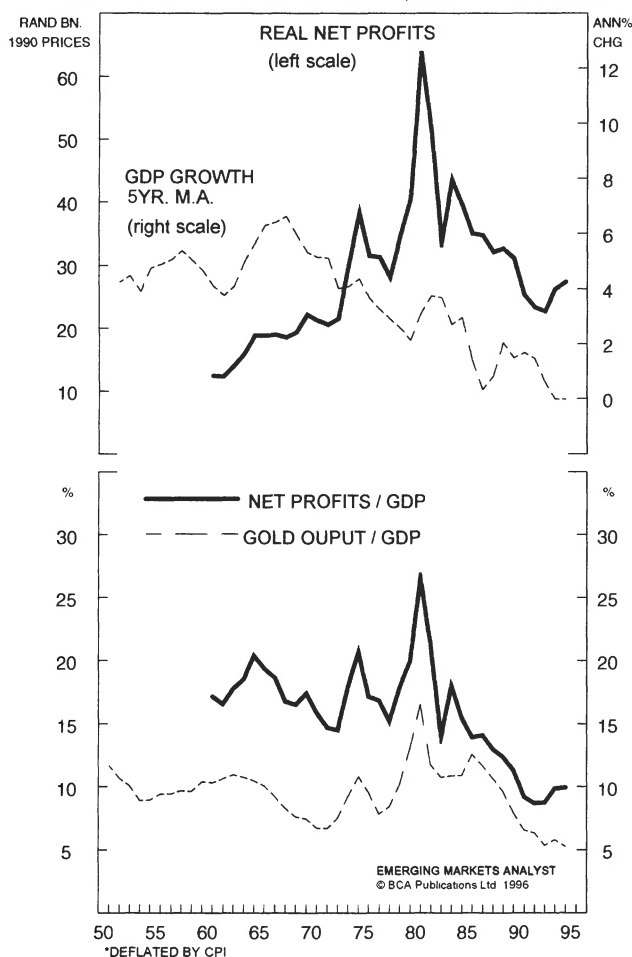
A significant rise in petroleum prices is not likely to happen spontaneously, however. Historically, all of the "oil crises" were triggered by Middle-East conflicts — either between Israel and the Arab countries, such as the 1967 and 1973 wars, or among/within the Arab countries themselves, like the 1979 Iranian revolution and the 1980 Iraq-Iran war, or the 1990 Iraqi invasion into Kuwait. If history is any guidance, the next oil crisis — if it is to occur at all — will also need a pretext, for example, a violent succession conflict in Saudi Arabia.

Although such a conflict need not bear directly on the Arab-Israeli peace process, it could undermine the confidence of some of the Arab leaderships, which will then slow down Arab-Israeli normalization.

Profits and growth in South Africa

The story of South-African profits is similar to that of Israel's. As illustrated in the top panel of Chart 8, the South African growth rate started its long-term decline in the late 1960s. During the 1970s, however, corporate profits had risen dramatically, and it was only in the 1980s that they, too, started to drop. The explanation for this divergence is again rooted in the behavior of the profit share.

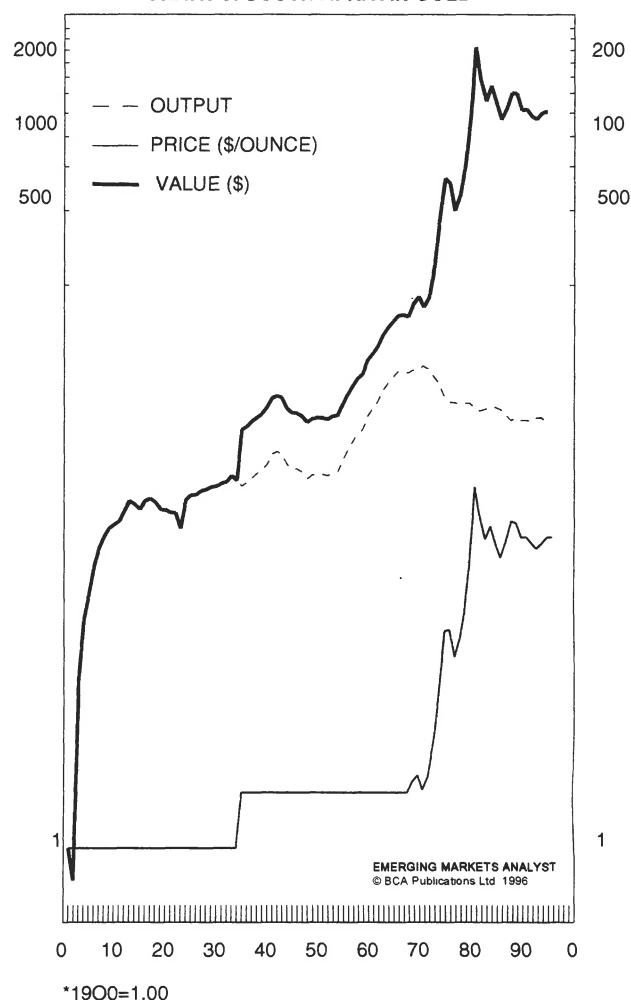
CHART 8: SOUTH AFRICAN PROFITS, GROWTH AND GOLD



The data at the bottom panel of Chart 8 show that between 1972 and 1980, the share of net profits in GDP had almost doubled, rising from 15% to 27%. As illustrated in the chart, the main cause was *gold*. Historically, revenues from gold exports were the main springboard for South Africa's industrialization, and despite significant corporate diversification since the Second World War, profitability remained highly dependent on the value of gold output.

Chart 9 outlines the determinants of this value since the turn of the century. Until 1970, the price of gold was fixed, so the value of gold output was entirely dependent on production levels. Production has increased more or less continuously until 1970, after which it reverted into a long term decline. At the time, the consequences of this reversal were temporarily masked by the end of the gold standard. The price of gold soared, raising the value of South African gold output despite declining production. By the early 1980s, however, the party was over. Gold prices began to fall and with stagnating production, the overall value of output went into a tailspin.

CHART 9: SOUTH AFRICAN GOLD*



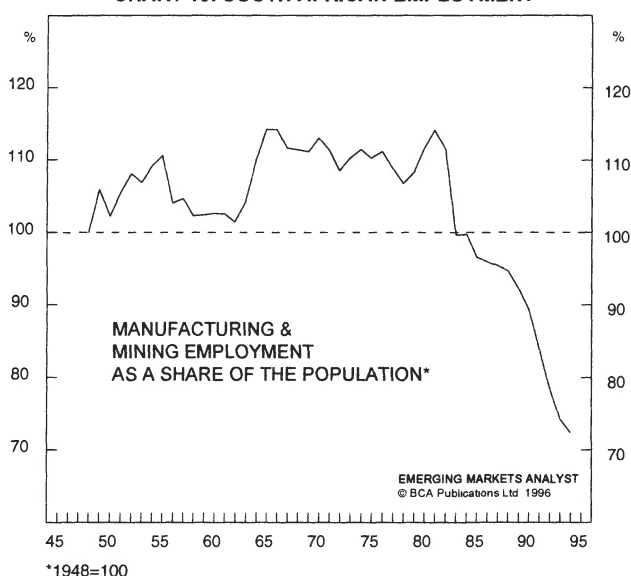
The social and political history of South Africa has been intimately related to these developments. Until the early 1970s, the South-African economy could have been characterized as suffering from a "labor shortage". Since gold producers had no control over the price of gold, and given that the geological nature of South African gold deposits limited the extent of mechanization, profit growth depended on higher output, and thus on the *increasing supply of cheap black labor*.

Apartheid was instrumental in achieving that end: restrictions on land ownership, occupational mobility and civil rights for blacks have all contributed to higher labor-force participation, while keeping wage cost in check.

The "New South Africa"

Since the 1970s, however, the combination of overall recession and declining gold output has changed South Africa into a "labor surplus" economy. As illustrated in Chart 10, the ratio of mining and manufacturing employment to the overall population

CHART 10: SOUTH AFRICAN EMPLOYMENT



(with 1948 set equal to 100) trended upward until the late 1960s, but then began to decline during the 1970s, reverting to a free-fall in the 1980s.

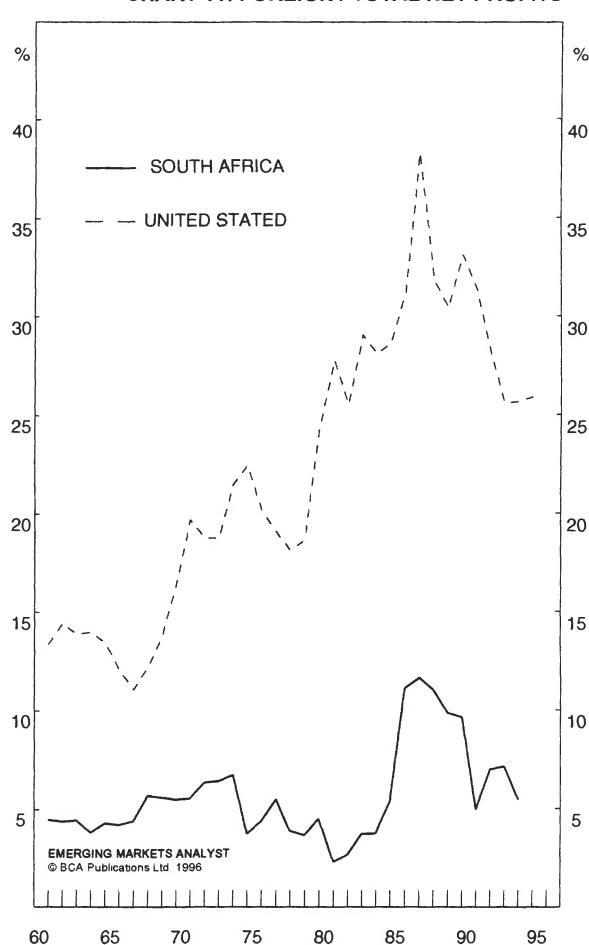
From that point onward, *apartheid* was no longer conducive to earnings growth. First, UN sanctions imposed during the 1970s meant that economic growth was now further constrained by South Africa's inability to run current account deficits. Second, and perhaps no less significant, the imposition of capital controls in order to avert the outflight of domestic capital meant that South African companies were more or less excluded from the globalization trend. The consequence, illustrated in Chart 11, was that in contrast to US companies who saw their profits from foreign subsidiaries almost tripled to over 25% of the total since 1960, the corresponding ratio for South Africa has remained stationary at around 5%.

The South African conglomerates had realized already in the 1970s that diversification away from gold would be necessary. Yet, with their gold profits temporarily soaring on the back of a gold price upswing, political action was put on hold. It was only with the price collapse since 1981 that South African "big business" got serious about ending *apartheid*. By the late 1980s they began actively supporting the ANC and the rest is history.

Prospects

This rationale seems consistent with recently-announced plans to reduce the conglomerates' "stranglehold" over the economy in order to raise competition and promote growth. Although the plan sits well with the ANC's political constituency, its implications for the conglomerates are far from

CHART 11: FOREIGN / TOTAL NET PROFITS

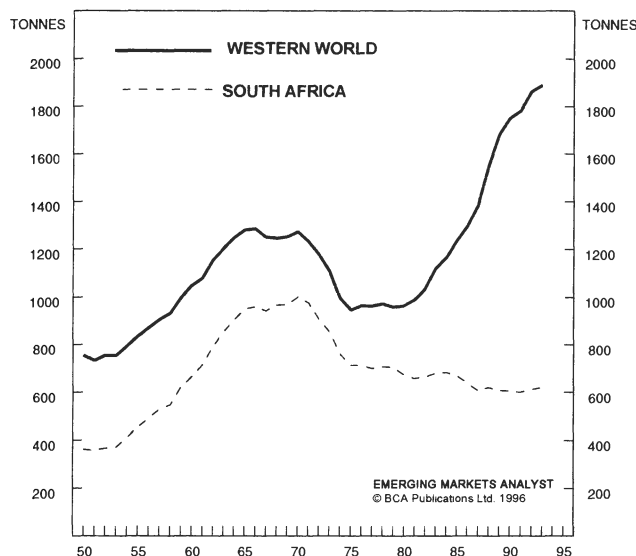


negative. Reading beyond the rhetoric, the most likely scenario is for capital controls to be removed, followed by a process of international "ownership swap". In this process, domestic assets will be sold to foreign investors and multinational companies, while the South African conglomerates will be allowed to take their first unconstrained step into the world economy.

The main risk for this transition is that, with black unemployment currently estimated at around 40%, economic growth will prove grossly insufficient to contain social unrest. In this context, success or failure could once again depend on a gold windfall.

As indicated in Chart 12, salvation is not likely to come from higher gold production. South-African gold mines are mature, their cost of production is among the highest in the world, and new gold deposits are hard to find. As a consequence, South Africa's share of western output has dropped to 32%, down from over 80% in the early 1970s, and the trend is likely to continue.

CHART 12: GOLD PRODUCTION

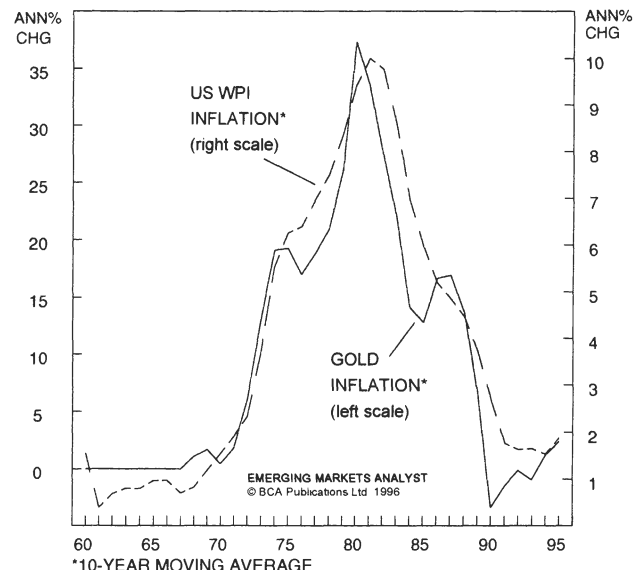


The outlook for gold prices is somewhat better. Chart 13 shows the close correlation between the rate of change of gold prices and US wholesale price inflation — both measured as a 10-year moving average. Although predicting these long-term trends is risky, it looks like both series may have troughed. However, in the absence of a 1970-style inflationary blowout the upside for gold prices is probably limited. Overall, then, the odds are that the South-African transition will not be rolling on a gold carpet.

Investment conclusions

- The Arab-Israeli peace process and the democratization of South Africa are driven by the need to reverse a protracted profit crisis. ***In both cases, the risk of domestic political backlashes in the coming years is offset by strong support from local business elites and multinational corporations.***
- With foreign investment by Israeli and South African companies set to rise significantly, profits are no longer constrained by domestic economic conditions. ***The prospects for long-term earnings growth are now excellent in both countries.***

CHART 13: PRICE AND GOLD INFLATION



- As Israel and South Africa open their economies, trade liberalization will likely result in ***larger current account deficits and greater currency volatility.***

- The end of the superpower confrontation has alleviated tensions in the Middle East. The prospects for an "Emerging Middle East", however, ***depend on the extent to which regional economic growth can compensate for forgone oil revenues.*** Social instability in the Persian Gulf means that a new conflict-driven oil crisis cannot be ruled out.

- In South Africa, the move toward a non-racial democracy has coincided with the closing of the "gold era". Given the need for South-African conglomerates to diversify away from gold, ***capital decontrols and corporate restructuring are imminent.***

- The South-African transition is likely to be painful for labor, ***and with black unemployment already at intolerable levels, the potential for social unrest remains high.*** E_{N_A}